Edited Minutes of the Monetary Policy Committee Meeting (No. 7/2018)
14 November 2018, Bank of Thailand
Publication Date: 28 November 2018

Members Present

Veerathai Santiprabhob (Chairman), Mathee Supapongse (Vice Chairman), Paiboon Kittisrikangwan, Sethaput Suthiwart-Narueput, Kanit Sangsubhan, Subhak Siwaraksa, and Somchai Jitsuchon

The Global Economy

Thailand's trading partner economies grew at a moderating pace as previously assessed. This was attributable to impacts of trade protectionism measures on global trade volume. **Advanced economies** would likely continue expanding, particularly the US economy which was supported by a robust labor market, strong consumer confidence, income tax cuts, and fiscal stimulus. The euro area was projected to expand, although private consumption could slow down as consumer confidence was weighed on by political uncertainties. Japan grew on the back of private consumption on account of a strong labor market, while private investment continued to expand despite the temporary impact of natural disasters during the third quarter. **China** would likely expand at a slower pace due to the Chinese government's financial stability measures to lower debt. Nevertheless, the Chinese government continued to implement a series of measures to support economic growth. **Asian economies** were expected to moderate on account of exports and consumption, but government policies aimed at supporting investment would play a role in holding up growth to some extent. **Inflation in trading partner economies** increased slowly mainly on the back of rising energy and fresh food prices, while core inflation was largely unchanged. With regard to **monetary policy of trading partners**, the Federal Reserve (Fed) continued with its tightening cycle as previously assessed, while the Bank of Japan (BOJ) and the European Central Bank (ECB) were expected to keep their accommodative monetary policy stance for some time. Monetary policy stance in Asia became increasingly diverging. Central banks in some countries such as the Philippines and Indonesia tightened monetary policy in order to stabilize rising inflation or to curb financial market volatilities, respectively. Meanwhile, other central banks such as the People's Bank of China still maintained accommodative monetary policy in response to slowing economic growth.

The Committee viewed risks to trading partners' growth largely unchanged from the previous assessment. Key risks included uncertainties pertaining to US trade protectionism and retaliatory measures by major economies, together with geopolitical risks that could cause volatilities in financial and commodity markets. Nevertheless, impacts of trade protectionism measures on the Chinese and Asian economies were expected to be more pronounced in the fourth quarter this year and would further escalate next year, as reflected in a decline in advance export orders and signs of trade diversion mainly in commodity markets. For instance, China increased imports of soybeans from Brazil and natural gas from Australia, Russia, and other countries, while the US started to export soybeans to Europe, Argentina, and other countries. In this regard, the Committee saw the need to closely monitor developments and assess impacts of trade protectionism measures between the US and China—both the negative effects on export and domestic markets as well as the positive effects due to investment diversion that could have a bearing on the manufacturing sector and the labor market in Thailand going forward.

<u>The Financial Markets</u>

Concerns over US trade protectionism measures and a sooner-than-expected normalization by the Fed posed downward pressures on Asian currencies, especially the Chinese yuan and currencies of countries with a strong link with China. Nevertheless, foreign investors reallocated investments from vulnerable emerging markets to other economies, including Thailand, which had sound fundamentals and relatively stronger external stability. This resulted in capital inflows to Thailand's long-term bond market toward the end of October. Thus, long-term bond yields declined. Meanwhile, short-term bond yields rose on account of market expectations of future policy rate increases. With regard to equities, foreign investors continued to sell off emerging market stocks, but the Stock Exchange of Thailand (SET) index fell relatively less than other emerging market indices due mainly to demand from domestic investors. On exchange rates, the baht was volatile against the US dollar and increasingly influenced by external factors. The Thai currency weakened in the same direction as regional currencies owing to rising concerns on risks to the global economy.

The Committee viewed that the global financial markets remained highly uncertain in the period ahead due to key factors such as (1) directions of monetary policy in advanced economies and (2) trade protectionism measures that could be intensified and affect the global economy and cross-border capital flows. This would put pressures on asset prices as well as exchange rates, especially of emerging markets with weak economic fundamentals and strong trade linkages with China and Europe. The Committee would thus continue to closely monitor developments of financial markets and exchange rates as well as impacts on the economy going forward.

<u>Domestic Economic Conditions</u>

The Thai economy would continue to gain traction. Despite signs of moderation in merchandise exports and tourism, domestic demand momentum continued to expand. The **value of merchandise exports** showed some signs of slowing down. This was partly owing to impacts from trade protectionism, the slowdown phase of electronic product life cycles, and temporary factors due to a typhoon affecting Japan, Hong Kong, and the Philippines. Looking ahead, merchandise exports were expected to register slower growth as impacts from trade protectionism on external demand would be more pronounced. This was in line with a softer outlook of export indicators—both advance orders and imports of raw materials. Despite openings of new airline routes from many countries to Thailand toward the end of the year, **exports of services** would likely slow down mainly due to the lower number of Chinese tourists following the Phuket tour boat sinking incident, slowing growth of the Chinese economy, yuan depreciation, dengue outbreaks in the southern Thailand, and the Chinese government's strengthened safety standards applied to countries favored by Chinese tourists. Meanwhile, domestic demand momentum increased. **Private consumption** continued to expand across all product categories in tandem with improved income and consumer confidence. In particular, increases in income of non-agricultural households were increasingly broad-based across all sectors and were sustained by government policies, including additional measures to support the low-income elderly and value-added tax refund for low-income earners. However, purchasing power of consumers was still held down by elevated household debt and low prices of some agricultural products such as rubber, palm, and sugar cane. In addition, exports of agricultural products that were highly dependent on Chinese demand, such as cassava and rubber, might be affected by the Chinese economic slowdown as a result of trade protectionism measures. **Private investment** was expected to continue expanding on the back of increased clarity on public-private partnerships (PPP) projects for infrastructure investments, improved business confidence, and the relocation of production base of foreign corporations in electronics industries to Thailand. **Public expenditure** was expected to moderate slightly due to delayed investment of some state-owned enterprises; for instance, the State Railway of Thailand was reassessing the relative priority of the seven routes in the second phase of dual-track railway projects. Meanwhile, investment by the central government was expected to continue growing thanks to progress on construction of motorway projects and disbursements on supplementary budget for fiscal year 2018.

The Committee engaged in an extensive discussion regarding the outlook of exports in the period ahead as the global economy and global trade were subject to downside risks. Clearer signs of impacts of trade protectionism started to be observed. Chinese businesses began to gradually run down their inventories and reduce imports of raw materials due to concerns over trade protectionism measures by the US. As a result, Thailand's exports of supply-chain products such as hard disk drives, rubber, and rubber products to China were projected to contract. In addition, exports would likely be affected by the slowdown phase of electronic product cycles, particularly on account of a decline in demand for smart phones in the global market that turned out faster and greater than expected. However, the relocation of production base of electronics industries to Thailand would partly help alleviate such impacts. Moreover, the Committee viewed that, although external demand began to slow down, an increasingly stronger domestic demand would play a role in driving Thailand's growth in the period ahead. Nevertheless, the Committee would closely monitor those external impacts on merchandise exports and tourism.

Headline and core inflation were slightly higher than previously assessed in September and October on account of (1) higher energy prices in line with global crude oil prices and (2) higher fresh food prices in all categories except prices of vegetables and fruits. This was due to a large agricultural output thanks to favorable weather conditions. Meanwhile, prepared food prices increased in tandem with rising transportation costs. **Looking ahead, annual average headline inflation would likely increase at a gradual pace** with greater downside risks due to volatile energy and fresh food prices. Core inflation was expected to rise slowly broadly in line with the previous assessment given gradual improvement in demand-pull inflationary pressures. Nevertheless, the Committee viewed that structural changes contributed to more persistent inflation than in the past. Such changes included impacts from the expansion of e-commerce, rising price competition, as well as technological development which reduced costs of production.

Financial stability remained sound overall but there remained a need to monitor some pockets of risks that might pose vulnerabilities to financial stability in the future. With regard to **leverage**, while the seasonally adjusted household debt to GDP ratio fell slightly in the second quarter of 2018, it remained high relative to those of other emerging market economies. Credit quality of mortgage loans must be monitored as the non-performing loan ratio (NPL) remained at a high level. Household debt accumulation must also be monitored, particularly mortgage loans in the period before the revision in the macroprudential measure on mortgage loans[1] would become effective as well as auto loans where credit standards became looser due to increasing competition. As a result, deleveraging could occur only slowly. Meanwhile, the non-financial corporation debt to GDP ratio continued to decline. Private businesses turned to raise funds through commercial banks instead of the bond market; however, large corporates would continue to increasingly raise funds through the bond market. Debt serviceability of small and medium-sized enterprises (SMEs) with rising NPLs must still be monitored, particularly businesses affected by structural changes such as rice mills and wholesale and retail businesses. With regard to **asset prices**, volatilities of the SET index rose in tandem with global markets, while the price-earnings ratio (P/E ratio) fell slightly below a historical average. In addition, tightening financial conditions could lead to higher borrowing costs in the bond market and affect debt rollovers, particularly in the case of companies issuing bonds with low credit rating or unrated bonds that were mostly in the real estate sector. With regard to the **property sector**, the house price index increased but did not accelerate. Demand for real estate continued to expand, especially condominium purchases driven in part by foreign demand mostly from Hong Kong, China, and Singapore. The Committee saw the need to monitor developments of foreign demand in the period ahead as there remained risks of a possible decline in demand following the Chinese economic slowdown. As for developers, funds were increasingly raised in the low interest rate environment through commercial banks as well as the bond market. This would increase debt rollover risks as financial conditions became tightened. Meanwhile, commercial banks started to compete to a lesser extent in extending mortgage loans and now accepted somewhat lower credit risks. However, the share of new mortgage loans with high loan-to-income (LTI) ratios was still rising, while the debt-to-service ratios (DSR) of low-income households remained elevated. The **search-for-yield behavior** remained present in the prolonged low interest rate environment. This was evident in a persistently high asset growth among saving cooperatives, as some large saving cooperatives increasingly engaged in taking deposits and lending to other cooperatives, as well as increased investment in both equities and debt instruments. Such tighter linkages contributed to further build-up of vulnerabilities. Investment in mutual funds grew at a slower pace, which was in part due to a decline in foreign investment fund (FIF) investment since the previous year. The Committee discussed risks to the financial system arising from the prolonged low interest rate as well as approaches to address and prevent such risks that included elevated household debts, rising competition in the mortgage loan market, expansion of saving cooperatives, debt serviceability of SMEs, and acceleration in borrowing by large corporates.

Monetary Policy Decision

The Committee judged that the Thai economy continued to gain traction. Despite signs of moderating external demand, domestic demand continued to expand. The annual average headline inflation was expected to rise gradually in line with the previous assessment. However, downside risks increased given volatile energy and fresh food prices. Meanwhile, core inflation was projected to edge up slowly as previously assessed. Overall financial conditions were accommodative and conducive to economic growth. Financial stability remained sound overall despite some pockets of risks which warranted monitoring. Risks arising from competition in the mortgage loan market, which led to looser credit standards,

[1] Further information: https://www.bot.or.th/Thai/PressandSpeeches/Press/News/2561n7261t.pdf

were addressed to a certain extent by the revision in the macroprudential measure on mortgage loans in order both to upgrade financial institutions' credit underwriting standards to better reflect risks and to pre-empt systematic risks. Nevertheless, the Committee would closely monitor developments in the mortgage loan market and adjustments in the property sector, particularly in the period before the macroprudential measure on mortgage loans would become effective, as well as monitor build-up of vulnerabilities in other pockets resulting from the prolonged period of accommodative financial conditions.

In their policy deliberation, the Committee voted 4 to 3 to keep the policy rate unchanged at 1.50 percent. Three members voted to raise the policy rate by 0.25 percentage point to 1.75 percent. The Committee discussed key considerations underpinning policy decision. Their conclusions were as follows.

(1) The Thai economy continued to gain traction despite some signs of moderating export growth. This was in part attributable to impacts from trade protectionism measures between the US and China, the slowdown phase of electronics product life cycles, and trading partner countries' weather conditions which were temporary factors. Meanwhile, domestic demand momentum increased, particularly on account of private consumption that continued to expand on the back of improvement in income and strong consumer confidence. Private investment was expected to expand thanks to the relocation of production base to Thailand and a greater clarity on PPP infrastructure investment projects. However, the Thai economy still encountered increased downside risks arising from impacts from trade protectionism that could be greater than expected as well as from geopolitical risks.

Most Committee members viewed that the current accommodative monetary policy stance remained necessary to support the continuation of economic growth. In particular, the Thai economy still faced downside risks from impacts of trade protectionism measures which were highly uncertain and a slowdown of tourism. In addition, the strength of private consumption and investment, which would be Thailand's growth momentum in the period ahead, must be monitored. Meanwhile, **some Committee members viewed that the economy was sufficiently robust and would not significantly slow down.** Therefore, a gradual reduction in the degree of monetary policy accommodation at this juncture would not much affect economic growth. Instead, it would reduce financial stability risks, and that would be conducive to sustainable economic growth in the long term.

(2) Headline inflation was expected to rise gradually. However, downside risks remained owing to volatile energy and fresh food prices. Meanwhile, core inflation was projected to edge up broadly in line with the previous assessment given the gradual build-up of demand-pull inflationary pressures. This was partly a result of structural changes such as the expansion of e-commerce, rising price competition, and productivity upgrades that reduced production costs, all of which could result in more persistent inflation than in the past. **The Committee viewed that current accommodative monetary policy had allowed the headline inflation trajectory to be consistent with the inflation target**. The Committee also viewed that a prolonged period of low inflation was due mainly to supply-side factors and structural changes despite the economy continuing to expand. As such, some Committee members viewed that maintaining the current level of monetary policy accommodation would not help accelerate inflation.

(3) Financial stability remained sound overall but some pockets of risks that might pose vulnerabilities to financial stability warranted monitoring going forward. According to the

Committee's assessment, risks pertaining to competition in the mortgage loan market were addressed to a certain extent through the revision in the macroprudential measure on mortgage loans. In any case, the Committee would monitor the following risks going forward. First, although the household debt to GDP ratio gradually declined, it remained high relative to that of emerging markets. Credit quality of mortgage loans had yet to improve and auto loans were expected to accelerate. Moreover, the prolonged low interest rate could affect savings going forward. Second, other types of search-for-yield behavior in the prolonged low interest rate environment could lead to underpricing of risks. For example, savings cooperatives continued to provide high returns to members, resulting in high growth of their assets that could pressure them to search for higher returns. Meanwhile, large saving cooperatives played a greater role in the saving cooperative system by increasingly engaged in extending loans to other saving cooperatives. Moreover, given the prolonged low interest rate environment, large corporates accelerated their funding through both commercial banks and the bond market in order to invest in both existing and non-core businesses including some overseas businesses. Therefore, these risks would be more closely monitored.

The Committee viewed that an appropriate mix of policy instruments, both policy interest rate and macroprudential measures, was necessary to effectively address stability in the financial system. However, macroprudential measures could not be employed in place of monetary policy, as macroprudential measures were rather complementary measures to address pockets of risks. **Some Committee members concerned that vulnerabilities that began to build up in the financial system** would affect sustainable economic growth in the long term. They viewed that vulnerabilities in the financial system started to become more widespread due partly to the prolonged low interest rate environment, which would induce households and businesses to underestimate potential changes in financial conditions. Therefore, monetary policy should play a role in preserving financial stability in conjunction with macroprudential measures.

In addition, the Committee discussed conditions and appropriate timing to begin normalizing monetary policy in the future. The Committee viewed that, should economic expansion continue and inflation move within the target, the need for currently extra accommodative monetary policy would start to be gradually reduced, while the need to have policy space to cushion against possible risks to growth in the future would be increasing. The Committee's evaluation of the appropriate conditions would be data dependent, including careful assessment of the outlook of economic growth, inflation, and financial stability risks, to support an appropriate monetary policy consideration going forward.

Monetary Policy Group
28 November 2018